



Recent Economic Developments

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CAUTIOUS OPTIMISM THROUGH A SOFT PATCH

The U.S. economy has demonstrated remarkable resilience in the face of terrorism, rising international tensions, corporate scandals, and falling stock prices. Despite these shocks, the economy has now been growing for more than a year, and forecasters believe that growth will accelerate in 2003, following the current soft patch. Accelerating growth is essential for restarting employment growth. Economic fundamentals do point to renewed growth, but significant risks persist. The economic outlook thus remains one of cautious optimism.

Key Drivers of the Recovery:

Consumer Spending and Productivity Gains

GDP Growth in 2002 was moderate, though uneven. GDP growth averaged about 2.9 percent for the year. Forecasters see steady improvement in the coming year.

Consumer Spending, fueled by increases in personal income and rising home values, has supported the recovery, even as business hiring and investment have struggled.

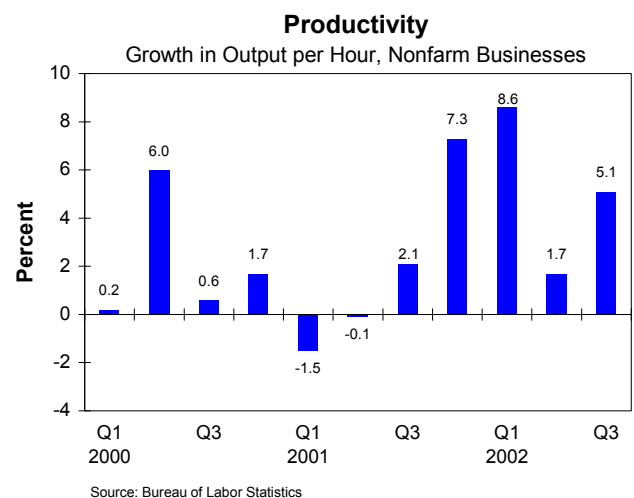
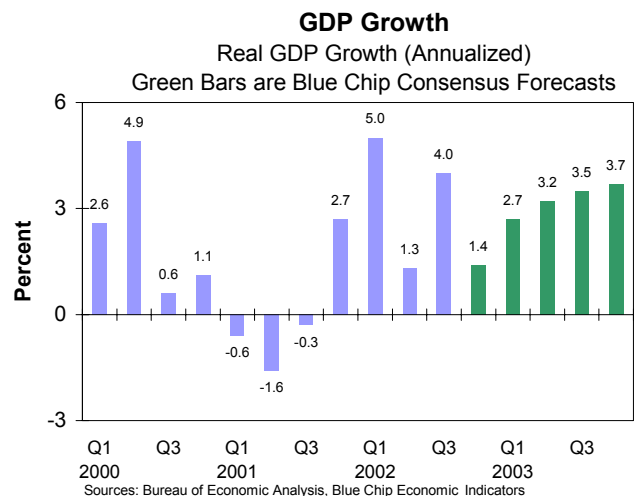
Productivity grew strongly during the first three quarters of 2002, at an average rate of over 5 percent. Productivity increases are a key driver of wage gains.

Housing markets have continued to be strong, supported by low mortgage rates.

Personal Income grew rapidly in 2002; disposable income in November was up 8 percent over the previous year, boosted by both wage gains and lower taxes.

Inventories are low by historical standards, boding well for future growth.

The **Service** sector has continued to expand even as other sectors have lagged.



Areas of Weakness:

Employment and Business Investment

Declines in **Business Investment** drove the 2001 recession and slowed the subsequent recovery. Investment declined for eight straight quarters through Q3 2002; declines have slowed in recent quarters.

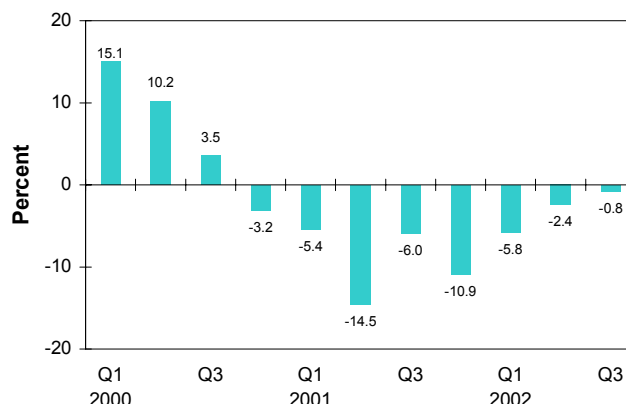
Employment growth stalled in late 2002, with significant declines in November and December. The unemployment rate ended the year at 6 percent, and the number of long-term unemployed was over 1.7 million.

Capacity Utilization in the industrial sector has been low, hovering around 75 percent, well below the 82 to 83 percent levels seen in the late 1990s.

Foreign Economies have been weak relative to the U.S. Real growth has been weak in Japan, Europe, and Latin America, and forecasters see a continuation into 2003. Weak demand overseas will limit export growth.

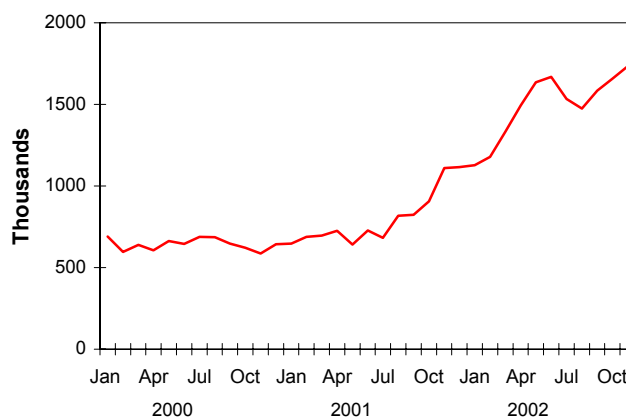
Retail Sales were weak during the holiday season. Chain store sales, for example, rose a mere 1 percent on a year-over-year basis. A strong surge in sales late in December was not enough to offset weakness earlier in the month.

Fixed Nonresidential Investment
Real Annualized Growth Rate



Source: Bureau of Economic Analysis

Number Unemployed for 27 Weeks or More



Source: Bureau of Labor Statistics

Other Developments

After lowering the overnight interest rate to 1.25 percent in November, the **Federal Reserve** made no changes at their December meeting. Minutes of their November meeting indicate some concern about the possibility of deflation—general price declines. However, Fed officials have recently emphasized that deflation is extremely unlikely and, furthermore, that they are prepared to combat deflation if it were to arise.

The **Current Account Deficit**, which measures flows of resources into and out of the U.S., continues to be at historically high levels, at close to 5 percent of GDP.

Inflation remains benign.

The Dollar has weakened somewhat in recent months.